APPLICATION OF

VIRGINIA ELECTRIC AND POWER COMPANY **CASE NO. PUE980333**

For approval of a special rate and contract pursuant to § 56-235.2 of the Code of Virginia

REPORT OF ALEXANDER F. SKIRPAN, JR., HEARING EXAMINER

November 20, 1998

On June 22, 1998, Virginia Electric and Power Company ("Virginia Power" or "Company") filed an application seeking approval of a special rate and contract for the electric service it will provide to Chaparral (Virginia), Inc. ("Chaparral") at the steel recycling facility Chaparral is constructing in Dinwiddie County, Virginia. Virginia Power is offering Chaparral a special rate for electric service pursuant to § 56-235.2 of the Virginia Code. This application was filed pursuant to § 56-235.2 and the Commission's Guidelines for Filing an Application to Provide Electric and Gas Service under a Special Rate, Contract, or Incentive, 20 VAC 5-310-10, adopted in Case No. PUE970695.

On July 16, 1998, the Commission issued an Order for Notice and Hearing that directed Virginia Power to give notice of its application by newspaper publication and by serving copies of the order on the chairman of the board of supervisors of Dinwiddie County and Virginia Power customers served under Rate Schedule GS-4, Curtailable Schedule CS, and Rate Schedule 10. In its July 16 order, the Commission also set the application for hearing on September 17, 1998, established a procedural schedule, and assigned the matter to a Hearing Examiner.

On July 30, 1998, Chaparral filed both a Notice of Protest and a Protest to become a party to the proceeding. On August 21, 1998, Northern Virginia Electric Cooperative ("NOVEC") asked to be added to the service list for this case. On August 28, 1998, the Virginia Committee for Fair Utility Rates ("Virginia Committee")[1] filed a Motion for Leave to File Notice of Protest,

[1] The Virginia Committee is comprised of AlliedSignal Inc.; Amoco Oil Company; Anheuser-Busch, Incorporated; Canon Virginia, Inc.; DuPont Polyester Films; E. I. Du Pont de Nemours & Company, Inc.; Ford Motor Company; General Motors Corporation; Nabisco Brands, Inc.; National Welders Supply (Chesterfield) Newport News Shipbuilding and Dry Dock Co.; Praxair, Inc.; Reynolds Metals Company; Siemens Automotive, L.P.; Stone Container Corporation; Union Camp Corporation; United States Gypsum Company; Wayn-Tex, Inc.; and Westvaco Corporation.

its Notice of Protest, and a Protest. By Hearing Examiner's Ruling dated August 31, 1998, the Virginia Committee's Notice of Protest was accepted for filing out of time. Nonetheless, on September 15, 1998, the Virginia Committee requested that its status be changed from protestant to intervenor.

The evidentiary hearings on the application were held in Richmond on September 17 – 18, 1998. Counsel appearing were: James C. Roberts, Esquire, and Richard D. Gary, Esquire, counsel for the Company; Michael Kaufmann, Esquire, on behalf of Chaparral; and Sherry H. Bridewell, Esquire, and Allison L. Held, Esquire, counsel for the Commission's Staff. Filed with this Report are the transcripts from the hearings. Proof of public notice was marked as Exhibit Company-1 and admitted into the record. The Company, Chaparral, and Staff filed briefs on October 16, 1998.

SUMMARY OF THE RECORD

Construction of Chaparral's steel recycling facility represents an investment of approximately one-half billion dollars.[2] When completed and at full production, Chaparral's new facility will produce about 1.2 million tons of structural steel annually and directly employ about 400 people with an annual payroll in excess of $14 million.[3] The facility also will consume a ***Proprietary Annual Level of Electricity***[4] with a ***Proprietary Peak Load*** and a ***Proprietary Load Factor***. Chaparral's proposed Dinwiddie facility, coupled with an existing sister plant in Midlothian, Texas, gives Chaparral's parent, Texas Industries, Inc. ("TXI") the capacity to "recycle eight percent of the cars and light trucks scrapped in the United States each year."[5]

On April 13, 1998, Virginia Power and Chaparral signed an Agreement for Electric Service ("Agreement").[6] The Agreement calls for Chaparral to purchase all of its electricity from Virginia Power for the next four years in exchange for special rates, terms, and conditions.[7] On June 11, 1998, Virginia Power and Chaparral amended the Agreement to extend the date for Virginia Power to file the Agreement with the Commission from June 12, 1998, to June 22, 1998.[8]

In support of its application, Virginia Power filed both redacted and proprietary versions of the direct testimonies of E. Paul Hilton,[9] vice president-regulation for Virginia Power, and Larry L. Clark,[10] vice president and controller of TXI. Mr. Hilton's direct testimony addresses:

---

[2] Exhibit LLC-17, at 3, 13.
[3] *Id.* at 5.
[4] Throughout this report items deemed to be proprietary will be labeled in a ***bold italic*** font. Proprietary items are defined in the Proprietary Attachment to this report.
[5] Exhibit LLC-17, at 4.
[6] Exhibit Company-2, at 2.
[7] *Id.* at 2-3.
[8] Exhibit Company-4, at 10, Amendment No. 1.
[9] Exhibit EPH-10; Exhibit EPH-P-11.
[10] Exhibit LLC-17; Exhibit LLC-P-18.

(i) the importance of flexible rate design in regards to economic development; (ii) the benefits associated with Chaparral's planned facility; (iii) the basic structure of the special rates provided to Chaparral by the Agreement; and (iv) plans for the margins to be earned from Chaparral. Mr. Clark's direct testimony provides insights into Chaparral's decision to locate its new facility in Virginia Power's service territory.

According to Mr. Hilton, the general premise of the special rates offered by Virginia Power to Chaparral is that the new facility will not affect the Company's generation expansion plans.[11] Because Chaparral's entire load is interruptible, Virginia Power designed its special rates to recover its estimated incremental costs of production and to produce additional margins it will share with all other customers.[12] Specifically, the special charges under the Agreement include the following:

(i) a ***Monthly Administrative Charge*** designed to recover costs associated with the communication of hourly prices, billing, coordination of services and administration of the Agreement;[13]

(ii) a ***Monthly Billing Demand Charge*** calculated to cover costs of transmission facilities and ancillary services;[14]

(iii) a ***Generation Capacity Adder ("GCA")*** rate per kWh intended to reflect the greater market value of capacity during the ***Limited Number of Hours*** each year in which energy is available in the market, but at a premium price – well above the incremental cost of production.[15] The ***GCA*** rate increases annually to levels specified in the Agreement based on projected annual costs per kW for market capacity;[16]

(iv) an **Energy Charge** based upon hourly projections of the Company's variable marginal cost per kWh (*i.e.*, system lambdas) plus an additional per kWh ***Margin***.[17] Virginia Power will provide projections of its hourly system lambdas to Chaparral one day in advance.[18] The additional ***Margin*** represents a contribution toward fixed costs intended to benefit all other customers;[19] and

[11] Exhibit EPH-10, at 5.
[12] *Id.*
[13] *Id.* at 4.
[14] *Id.*
[15] *Id.* at 5.
[16] *Id.* at 4.
[17] *Id.* at 5; Exhibit Company-4, at attached Exhibit 5.
[18] Exhibit Company-4, at attached Exhibit 5.
[19] Exhibit EPH-10, at 5.

(v) a **Gross Receipts Charge ("GRC")** to recover gross receipts taxes associated with revenues collected by Virginia Power from Chaparral.[20]

Furthermore, the Company performed Virginia jurisdictional and Virginia class cost of service studies to demonstrate the impact of service to Chaparral under the Agreement.[21] These studies show that service to Chaparral under the Agreement increases the rate of return for the Virginia jurisdiction and for each Virginia customer class.[22] Mr. Hilton attributes this across-the-board positive result to the ***Margin*** earned from Chaparral.[23] Moreover, the inclusion of the ***Margin*** earned from Chaparral in its cost of service studies is consistent with the Company's proposed future ratemaking treatment of the Agreement.[24] Virginia Power will oppose any future adjustments designed to capture the difference between generally applicable tariff rates and the special rates it provides Chaparral.[25] As explained by Mr. Hilton, "[a]ny future ratemaking adjustments based on such comparisons would, in effect, require Virginia Power alone to bear the costs of the Commonwealth's economic development goals set forth in § 56-235.2."[26]

Mr. Clark testifies that the Agreement negotiated with Virginia Power was key to its decision to select the Dinwiddie site for its steel recycling facility.[27] Chaparral chose this site over several other sites in South Carolina, North Carolina, and Virginia based on its access to transportation, scrap metal, and electric power supply.[28] Nonetheless, Mr. Clark bluntly states:

> Were standard tariff rates the only one available, Chaparral would not have made the decision to locate in Virginia Power's service territory.[29]

Virginia Power also filed a report by the Center for Regional Analysis ("CRA") at George Mason University regarding the economic impact of Chaparral's business activities on the regional economy of the Counties of Dinwiddie, Chesterfield, Prince George, and the City of Petersburg.[30] CRA attempted to estimate the economic impact: (i) directly affected by Chaparral business activities; (ii) indirectly caused by inter-industry purchases of goods and services as they respond to changes in Chaparral business activities; and (iii) induced or created through household spending of those employed directly and indirectly through Chaparral business activities.[31] CRA found that Chaparral would be responsible for the creation of 1,227 temporary construction jobs

---

[20] *Id.*
[21] Exhibit EPH-P-12; Exhibit EPH-P-13.
[22] Exhibit EPH-P-14; Exhibit EPH-10, at 10.
[23] Exhibit EPH-10, at 10.
[24] *Id.* at 7.
[25] *Id.*
[26] *Id.* at 7-8.
[27] Exhibit LLC-17, at 10.
[28] *Id.* at 9.
[29] *Id.* at 10.
[30] Exhibit Company-6.
[31] *Id.* at 5.

during 1998 and 1999, adding $54.4 million in personal income to the region.[32] By 2001, CRA expects Chaparral to create 1,280 permanent regional jobs, producing over $90 million in wages, interest and dividends from 1999 to 2001.[33] In addition, CRA predicts that Chaparral business activities will result in a contribution of $10.2 million in Virginia business taxes and $6 million in state and local income taxes from 1998 to 2001.[34]

No Protestant filed comments or direct testimony.

On September 4, 1998, the Staff filed the redacted and proprietary direct testimonies of Howard M. Spinner, senior utilities specialist in the Commission's Division of Energy Regulation;[35] the redacted and proprietary direct testimonies of Kimberly Boyer Pate, principal public utility accountant with the Commission's Division of Public Utility Accounting;[36] and the direct testimony of David R. Eichenlaub, assistant director in the Commission's Division of Economics and Finance.[37] Generally, the Staff supports approval of the Agreement.[38] However, the Staff raises several concerns and makes recommendations that, if implemented, could require the renegotiation of one of the Agreement's basic terms or significantly change future regulatory treatment of the Agreement.[39]

Mr. Spinner outlines Staff's concerns regarding the Agreement. Staff's primary concern is that sales to Chaparral may displace off-system sales.[40] Mr. Spinner projects that Virginia Power likely will earn higher margins on its off-system sales than from sales to Chaparral.[41] Because both fuel and base rates of Virginia Power's current customers are reduced by the margins earned from off-system sales, Mr. Spinner concludes that service to Chaparral has the potential to increase the rates of all other customers.[42] Therefore, Staff proposes a mechanism that would credit the Company's deferred fuel balance and base rate margins with the margins earned from electricity sold to Chaparral based upon the hourly locational marginal price at the Virginia Power/PJM interconnection.[43] In other words, as outlined in the testimony of Staff witness Pate, fifty percent of the estimated foregone margins that could have been earned from off-system sales to PJM would be credited to the deferred fuel balance and the remaining fifty percent of these

[32] *Id.* at 3, 5-7.
[33] *Id.*
[34] *Id.* at 3, 7-8.
[35] Exhibit HMS-19; Exhibit HMS-P-20.
[36] Exhibit KBP-24; Exhibit KBP-P-25.
[37] Exhibit DRE-31.
[38] Exhibit HMS-19, at 26.
[39] *Id.* at 28.
[40] *Id.* at 9.
[41] *Id.* at 9, 15-20.
[42] *Id.*
[43] *Id.* at 12, 26-27.

foregone margins would be credited to base rate margins.[44] Staff also proposes that Virginia Power retain (*i.e.*, record below-the-line) any margins actually earned from Chaparral.[45]

Other Staff concerns addressed by Mr. Spinner include: (i) whether the Agreement will cause Virginia Power to be capacity deficient;[46] (ii) the impact of the Agreement on the rates of customers served under Schedule Real Time Pricing ("RTP");[47] (iii) the accuracy of Virginia Power's lambda forecasts;[48] and (iv) the possibility of a large number of "me-too" requests for similar agreements.[49] Furthermore, Staff witness Eichenlaub questions the impact of service to Chaparral on Virginia Power's need for additional capacity.[50] If the Company fails to interrupt Chaparral during peak periods, Virginia Power may become capacity deficient.[51] Thus, Mr. Eichenlaub is concerned that the proposed Agreement does not appear to specify terms or limits regarding Virginia Power's ability to interrupt Chaparral.[52]

To address these Staff concerns, Mr. Spinner outlines the following additional Staff recommendations:[53]

- The Company should mitigate any potential adverse impacts on existing RTP customers that may arise as a result of the implementation of the proposed Agreement.

- In the event of significant structural changes in the electric supply industry resulting from restructuring activities on the state or federal level that require amendments to the proposed Agreement, the Commission should retain the right to review and consider whether such amendments are in the public interest. Virginia Power should be required to present proposed amendments to the Commission before the proposed effective date of the amendments.

- After Chaparral begins commercial operation and on an ongoing basis, Virginia Power should inform the Staff of any reconfiguration of Virginia Power's transmission delivery system resulting from the addition of Chaparral's load.

---

[44] Exhibit KBP-24, at 3.
[45] Exhibit HMS-19, at 12, 26-27.
[46] *Id.* at 13-14.
[47] *Id.* at 14-15.
[48] *Id.* at 22-23.
[49] *Id.* at 25.
[50] Exhibit DRE-31, at 3-6.
[51] *Id.* at 4-5.
[52] *Id.*
[53] Exhibit HMS-19, at 27-28.

- Virginia Power should have a means of curtailing Chaparral's load unilaterally.

On September 11, 1998, Virginia Power filed the rebuttal testimonies of Messrs. Hilton and Clark. Mr. Hilton expressed the Company's disappointment with Staff's testimony that he characterized as advocating sale of electricity in the wholesale market over support of economic development in its certificated service territory.[54] Mr. Hilton contends that the wholesale market is volatile and has been in existence for only a few months.[55] He criticizes Staff for being willing to gamble away known margins from Chaparral for uncertain wholesale margins.[56] In addition, Mr. Hilton argues that Staff's proposal violates the Stipulation adopted by the Commission in Case No. PUE960296, which limits any earnings test to "those regulated revenues and related expenses and investments incurred in furnishing electric utility service to Virginia jurisdictional customers."[57] As to Staff's concern regarding customers served under Schedule RTP, Mr. Hilton explains that charges to RTP customers will not vary regardless of whether it serves Chaparral under the Agreement or under Schedule GS-4.[58] Accordingly, Mr. Hilton maintains that neither base rates nor fuel rates will increase as a result of the special rate for Chaparral.[59]

Mr. Hilton also addresses the issue of interruption raised by Staff witness Eichenlaub. If Virginia Power needed to interrupt Chaparral, and Chaparral refused, Mr. Hilton testifies that "the Company could remotely disconnect Chaparral from the transmission line through the use of remotely activated disconnect switches."[60] Furthermore, because Chaparral is fully interruptible, Virginia Power will not include Chaparral's load in its generation planning studies.[61]

Mr. Clark focuses his rebuttal testimony on some of the economic development and business ramifications of Staff's recommendations. Principally, Mr. Clark believes that Staff ignores the public interest benefits represented by Chaparral and the Agreement and that Staff's approach could jeopardize future economic development efforts in the Commonwealth.[62] Mr. Clark also attempts to emphasize the importance of the special rate to Chaparral's decision to locate in Virginia. In this regard, Mr. Clark explains that the decision to proceed with construction of the Chaparral plant prior to approval of the Agreement was driven by market considerations within the steel industry and should not be taken as an indication that Chaparral may have located its plant in Virginia without an Agreement.[63]

---

[54] Exhibit EPH-33, at 1-2.
[55] *Id.* at 5.
[56] *Id.*
[57] *Id.*; Exhibit KBP-27 Stipulation at 6, Paragraph 5.
[58] Exhibit EPH-33, at 7.
[59] *Id.* at 7-8.
[60] *Id.* at 11.
[61] *Id.*
[62] Exhibit LLC-28, at 1, 10-12.
[63] *Id.* at 4-7.

Five public witnesses appeared during the hearing of September 17, 1998. Thomas K. Warren, representing Merck & Company in Elkton, Virginia ("Merck"), testified that Virginia Power should exclude Chaparral's demand from the calculation of the demand thresholds that trigger the peak pricing hours under Schedule RTP.[64] Mike Dunavant, an employee of Simms Metal America of Richmond ("Simms Metal"), explained that his firm, which recycles obsolete metals, is not opposed to the Agreement provided that the agreement does not disadvantage other businesses seeking to expand.[65] Dennis Morris, executive director of the Appomattox Basin Industrial Development Corporation ("ABIDCO"), described actions taken by his and other economic development organizations to convince Chaparral to locate in Virginia.[66] Mr. Morris further recounted the positive impact Chaparral's decision to locate in the area has had on both the recruitment of new businesses and plans for the expansion of existing industries.[67] Martin Long, Dinwiddie County Administrator, read a letter from the Dinwiddie County Board of Supervisors in which they expressed full support for the special rate offered by Virginia Power to Chaparral.[68]

Finally, John B. Sternlicht, policy and legislation director for the Virginia Economic Development Partnership ("Partnership"), read a letter on behalf of Barry E. DuVal, Secretary of Commerce and Trade for the Commonwealth of Virginia, describing the collaborative effort of the Commonwealth, local economic development officials, and Virginia Power to ensure that Chaparral chose Virginia for its facility.[69] Mr. Sternlicht also discussed the negative consequences, from an economic development standpoint, of requiring Virginia Power to pay customers for revenues it would have earned had it marketed that power out of state.[70] He argued that adopting the Staff's recommendations will: (i) encourage Virginia Power to assist economic development in states other than Virginia, (ii) reduce the likelihood of success for Chaparral, and (iii) damage the reputation of Virginia in economic development.[71] Lastly, Mr. Sternlicht addressed Chaparral's decision to proceed with construction before approval of the Agreement.[72] In this regard, Mr. Sternlicht provided the following example to demonstrate that Chaparral could not wait for all issues to be conclusively decided before it broke ground.

> For example, the Partnership agreed to seek to have legislation introduced to make the recycling tax credit more usable for Chaparral. There were no guarantees that this would be passed by the General Assembly, obviously, but Chaparral took our word that we would use our best efforts, and went forward with their plans.

---

[64] Warren, Tr. at 30-31.
[65] Dunavant, Tr. at 32-34.
[66] Morris, Tr. at 35-37.
[67] *Id.* at 37-40.
[68] Long, Tr. at 41-42.
[69] Sternlicht, Tr. at 43-44.
[70] *Id.* at 47-48.
[71] *Id.*
[72] *Id.* at 48-49.

> That is a large part of what constitutes Virginia's favorable business climate, which is perhaps our best asset.[73]

During the evidentiary hearing, the positions and recommendations of Virginia Power, Chaparral, and Staff remained relatively unchanged. Two notable issues developed by the parties during the hearings were: (i) the validity of CRA's economic findings; and (ii) the probability that Chaparral would have decided to locate in Virginia without the special rates of the Agreement.[74] As to CRA's economic findings, Staff initially objected to their admission because Virginia Power failed to offer a witness to sponsor the report.[75] Eventually, Staff dropped its objection and CRA's findings were admitted to record.[76] Nonetheless, Staff witness Eichenlaub remained skeptical of CRA's findings, stating that CRA bases its findings on "certain variables that may overestimate or overstate those benefits, not that they may not be there."[77]

In regards to whether Chaparral would have located in Virginia without the Agreement, Staff witness Spinner, during cross-examination by Chaparral's counsel, expressed his belief that Chaparral may be a "free rider" in that it may have chosen to locate in Virginia without a special rate.[78] In support of his belief, Mr. Spinner pointed to investments Chaparral has made in the Dinwiddie site prior to approval of the Agreement.[79] On rebuttal, Chaparral witness Clark attempted to lay the free rider issue to rest by explaining that like the changes in tax laws amended by the General Assembly, Chaparral relied upon the reputation of Virginia for operating in a reasonable manner concerning economic development when it made its decision to locate in Virginia after negotiating the Agreement with Virginia Power.[80]

DISCUSSION

When the Commission promulgated rules for special rates, contracts or incentives pursuant to Virginia Code § 56-235.2 D, it deferred adopting specific requirements for complying with the standards provided by the statute. Instead, the Commission found it more "prudent to review § 56-235.2 A applications on a case-by-case basis and gain experience before identifying more specific criteria."[81] This case marks the first § 56-235.2 A application. Though there are factual issues, most of the differences between the parties relate directly to conflicting interpretations of the statutory requirements of § 56-235.2.

---

[73] *Id.* at 49.
[74] Spinner, Tr. at 180.
[75] Tr. at 53, 55-57, 98; Hilton, Tr. at 60-65.
[76] Tr. at 250-51, 340-41.
[77] Eichenlaub, Tr. at 330-331.
[78] Spinner, Tr. at 186.
[79] *Id.* at 189-90.
[80] Clark, Tr. at 275-77.
[81] *Commonwealth of Virginia, at the relation of the State Corporation Commission, Ex Parte, In re: Promulgation of Guidelines for Special Rates, Contracts or Incentives pursuant to Virginia Code § 56-235.2 D,* Case No. PUE970695, Final Order at 10, (March 20, 1998) ("*Special Rates Order*").

In 1996, the General Assembly amended § 56-235.2 A to permit utilities to offer special rates, contracts or incentives as a means of attracting or retaining customers by adding the following language:

> Notwithstanding § 56-234, the Commission may approve, either in the context of or apart from a rate proceeding after notice to all affected parties and hearing, special rates, contracts or incentives to individual customers or classes of customers where it finds such measures are in the public interest. Such special charges shall not be limited by the provisions of § 56-235.4.

This new language removes a utility's duty to charge uniform rates to all similarly situated customers as provided in § 56-234 where the Commission finds that it is in the public interest to do so. In addition, removal of the limitation of § 56-235.4 permits the adoption of special rates, contracts or incentives that increase the operating revenues of a utility more than once within any twelve-month period.

Furthermore, when determining whether to approve a special rate, contract or incentive, the Commission must:

> ensure that such action (i) protects the public interest, (ii) will not unreasonably prejudice or disadvantage any customer or class of customers, and (iii) will not jeopardize the continuation of reliable electric service.[82]

Section 56-235.2 C directs the Commission to apply its expert judgment to a specific set of facts and circumstances to determine when special rates, contracts or incentives are in the public interest. For example, § 56-235.2 C(ii) requires that the Commission determine whether a special rate *unreasonably* prejudices or disadvantages a customer or class of customers. At a certain level of analysis, every special rate that produces less revenue for the utility than if the customer(s) were served under a conventional tariff tends to prejudice or disadvantage other customers. But the statute does not focus on *whether* other customers are prejudiced or disadvantaged, rather, the statute directs the Commission to inquire as to whether other customers are prejudiced or disadvantaged *unreasonably*. Such an inquiry requires an examination of the facts and circumstances of each special rate, including but not limited to: (i) the economic impact of gaining or losing the customer(s); (ii) the likelihood or probability the customer(s) would purchase from an existing tariff; and (iii) the related risks and benefits to be placed on all other customers. Accordingly, the level of prejudice or disadvantage to other customers that may be tolerated becomes a function of the relative level of benefits gained by offering the special rate.

[82] Virginia Code § 56-235.2 C.

Nonetheless, the General Assembly was careful to limit this analysis by directing the Commission to establish guidelines for special rates "that will ensure that other customers are not caused to bear increased rates as a result of such special rates."[83] In its *Special Rates Order*, the Commission agreed with the Hearing Examiner's finding that:

> the determination of whether other customers will bear increased rates as a result of a special offering should begin with a determination of whether the revenues from the special rate will exceed the utility's variable costs of providing service . . . [and] also include the impact of the special rate on total company revenues and expenses.[84]

Therefore, the Commission declined to specify a single means of evaluation, but was careful to maintain "the flexibility to evaluate a proposal using whatever kind of analysis that it determines to be appropriate in a particular case."[85]

During the hearing, Staff witness Spinner testified that he proposed a mechanism to impute lost margins from off-system sales because he interpreted § 56-235.2 D to require current customers to benefit with certainty.[86] As explained by Mr. Spinner, a special rate fails § 56-235.2 D in a situation where current rates remain unchanged, but could have been lower.[87] Interestingly, on brief, Staff does not cite to the requirements of § 56-235.2 D in support of its recommendations. Instead, Staff counsel argues that § 56-235.2 C is the touchstone for analysis.[88] But, even on brief, Staff does not provide a clear weighing or balancing of the public interest as contemplated by the statute.

Accordingly, in keeping with the statutory standards of § 56-235.2 C this report will examine, separately, below: (i) the impact of the proposed Agreement on the public interest, including the direct and indirect economic benefits associated with attracting Chaparral to Virginia, and the probability of attracting Chaparral without the Agreement; (ii) the impact of the proposed Agreement on other existing customers; and (iii) the impact of the proposed Agreement on service reliability.

The Impact of the Agreement on the Public Interest

All of the parties, including Staff, agree that Chaparral's decision to locate in Dinwiddie County increases commerce and associated employment and tax benefits.[89] Indeed, all parties,

---

[83] Virginia Code § 56-235.2 D.
[84] *Special Rates Order* at 11.
[85] *Id.*
[86] Spinner, Tr. at 156-58.
[87] *Id*. at 157-58.
[88] Staff Brief at 10.
[89] Exhibit HMS-19, at 7; Spinner, Tr. at 134-35; Virginia Power Brief at 4-8; Chaparral Brief at 30-33.

including Staff, support Commission approval of the Agreement. Staff, however, qualifies its support and makes several recommendations designed to mitigate any potential adverse impacts the Agreement may have on Virginia Power's other ratepayers.[90]

Staff did not conduct an examination of the economic or commercial benefits that will accrue to the Commonwealth because of Chaparral's decision to invest in Virginia.[91] Nor did Staff attempt to compare economic and commercial benefits with the degree to which other customers are prejudiced or disadvantaged to determine if other customers were unreasonably prejudiced or disadvantaged.[92] Nonetheless, Staff raises doubts regarding the level of economic benefits the Commonwealth will realize from Chaparral's proposed facility, and questions whether the proposed Agreement was critical to attracting Chaparral to Virginia.[93]

Economic Benefits

There is no disagreement as to the direct economic benefits associated with Chaparral's proposed facility. When completed, Chaparral will employ about 400 people with an annual payroll in excess of $14 million.[94] Moreover, Chaparral will become the largest taxpayer in Dinwiddie County and represents the largest economic investment in Virginia for 1997.[95]

In addition to direct economic benefits, Virginia Power submits CRA's findings to quantify the indirect and induced economic benefits of Chaparral's proposed facility.[96] According to CRA, by 2001 in addition to the 400 jobs that will exist at Chaparral, an additional 488 jobs will be created "due to the inter-industry purchases of Chaparral," and another 392 jobs will be created "due to the spending of households of those employed directly and indirectly through Chaparral business activity."[97] Given the scope of the economic benefits associated with Chaparral's proposed facility it is not surprising to find that it has the support of local, regional, and statewide governmental and economic development authorities.[98]

Though Staff did not undertake an independent investigation of the economic or commercial benefits associated with the construction of Chaparral's new facility in Virginia,[99] Staff questions the validity of CRA's findings.[100] On direct examination, Mr. Eichenlaub complained that CRA failed to provide adequate detail in support of its findings.[101] Specifically,

---

[90] Staff Brief at 7.
[91] Spinner, Tr. at 180-82.
[92] *Id.*
[93] Staff Brief at 4; Spinner, Tr. at 184.
[94] Exhibit LLC-17, at 5.
[95] Exhibit Company-9.
[96] Exhibit Company-6.
[97] *Id.* at 6.
[98] *Id.*; Exhibit Company-7; Exhibit Company-8.
[99] *See*, Spinner, Tr. at 191; Eichenlaub, Tr. at 329.
[100] Eichenlaub, Tr. at 326-28.
[101] *Id.* at 327.

Mr. Eichenlaub questioned the reasonableness of the employment multiplier of 3.24 and the average personal income of $35,446 incorporated into the CRA findings.[102] For example, Mr. Eichenlaub observes that CRA's average personal income of $35,446 is higher than the $35,000 average annual wage for Chaparral.[103] This concerns Mr. Eichenlaub because he expects Chaparral's annual wages to be higher than many other wages, especially service sector wages.[104]

CRA supported its findings with eight pages of text and thirteen pages of tables.[105] Many of the tables detailed employment projections for various years, showing the number of direct, indirect, and induced new employees in each of fifty-nine employment categories. Furthermore, CRA defines average personal income to include: (i) earnings such as wages and salaries; (ii) dividends; (iii) interest; (iv) rent; and (v) transfer payments received by residents.[106] Based on actual data from 1995, earnings such as wages and salaries accounted for only 75% of total personal income for the region.[107] This indicates that the average personal income of $35,446 actually includes average earnings such as wages and salaries of only $26,584,[108] which would be more in line with Mr. Eichenlaub's expectations.

As stated above, no one disputes the direct economic benefits, which are substantial in and of themselves. In addition, no one disputes that there will be additional indirect and induced economic and commercial activity. Indeed, on cross-examination Mr. Eichenlaub admitted that on a cursory review, CRA's findings "appeared to be somewhat reasonable."[109] Mr. Eichenlaub also testified that Staff did not propound any interrogatories to CRA because it did not focus on CRA's findings until two weeks before the hearings.[110] Accordingly, I find that CRA's findings provide useful information for gauging the economic impact of Chaparral's new facility. Furthermore, Virginia Power and Chaparral have demonstrated the economic and commercial impact of this project to be overwhelmingly substantial and in the public interest.

Free Rider Issue

Nonetheless, if Staff witness Spinner is correct in that Chaparral's decision to locate in Virginia did not hinge upon the Agreement, then the economic and commercial benefits, no matter how substantial, should not be given any weight in the ultimate determination of whether the Agreement is in the public interest. Put simply, it is not in the public interest to give free riders special rates. Special rates should be reserved for instances where they are necessary to attract or maintain customers. In situations where the cost of electricity is one of many factors that

[102] *Id.* at 327-28.
[103] *Id.*
[104] *Id.*
[105] Exhibit Company-6.
[106] *Id.* at 7.
[107] *Id.*
[108] $35,446 times 75%.
[109] Eichenlaub, Tr. at 330.
[110] *Id.*

influenced a decision, some weight, but maybe not full weight should be assigned to the associated economic and commercial benefits.

As with the determination of economic benefits, Staff did not focus much of its attention on whether Chaparral was a free rider.[111] Staff witness Spinner explains that he only looked at the rate impacts of the Agreement and his recommendations did not rely on a determination of whether Chaparral was a free rider.[112] In recommending approval of the Agreement, Mr. Spinner did not take a position on whether Chaparral is a free rider.[113] Only when pressed on cross-examination did Mr. Spinner speculate, based on his prior experience in Vermont and the fact that Chaparral had begun construction of the facility prior to approval of the Agreement, that Chaparral may be a free rider.[114] Nonetheless, Mr. Spinner pointed out factors, such as the prominence of electricity expense in relation to total expenses for Chaparral, that suggest Chaparral is not a free rider.[115]

Virginia Power witness Hilton testified that Virginia Power has received and, after analysis, rejected requests for rate concessions from other major customers seeking to locate in its Virginia service territory.[116] However, Virginia Power was convinced that Chaparral would not locate in its Virginia service territory without such concessions.[117] Chaparral witness Clark confirmed that it is typical for steel plants such as Chaparral's proposed facility to operate under a special contract or tariff.[118] As discussed above, Mr. Clark also testified that without the Agreement, Chaparral would not have chosen its current plant location.[119] Mr. Clark also took strong exception to any indication that Chaparral was a free rider.[120]

In this case, the record overwhelmingly supports a finding that Chaparral would not have chosen to locate in Virginia Power's Virginia service territory without some type of rate concession. The cost of electricity will be one of the key factors that ultimately will determine the success of the facility. Moreover, Chaparral possesses the unique characteristics of being a large, high load factor customer, operating twenty-four hours a day, seven days a week, that may be interrupted on very short notice. Thus, it is not hard to believe that Chaparral would expect, and other electric utilities would be happy to provide rate concessions. The only fact that suggests to the contrary is that Chaparral started construction prior to Commission approval of the Agreement. However, given the competitive nature of the electric industry, §56-235.2 of the Virginia Code, and the Commonwealth's reputation in economic development circles, I do not find Chaparral's commencement of construction to indicate it to be a free rider.

---

[111] Spinner, Tr. at 171-73, 185-86.
[112] *Id.* at 185-86.
[113] *Id.* at 186.
[114] *Id.* at 172, 182-86, 192-93.
[115] *Id.* at 171-73.
[116] Hilton, Tr. at 344.
[117] *Id.*
[118] Clark, Tr. at 94.
[119] Exhibit LLC-17, at 10.
[120] Clark, Tr. at 275-77.

Therefore, in summary, I find the economic benefits associated with Chaparral's proposed Dinwiddie facility to be substantial. Furthermore, Chaparral's decision to locate in Virginia was dependent upon the Agreement that is the subject of this case. Because of the high probability that Chaparral would not locate in Virginia without the Agreement, virtually full weight should be given to the substantial economic and commercial benefits in the ultimate determination of whether the Agreement is in the public interest.

The Impact of the Agreement on Other Customers

This area of inquiry concerns the impact of the proposed Agreement on Virginia Power's other Virginia jurisdictional customers. Specifically, this section examines the related risks and benefits placed on all other customers by the Agreement in order to determine whether approval of the Agreement will unreasonably prejudice or disadvantage any customer or class of customers.[121] Included in this examination is a determination of whether other customers will bear increased rates as a result of the Agreement.[122] Pursuant to the Commission's *Special Rates Order*, this examination will begin with a determination of whether the revenues from the Agreement exceed Virginia Power's variable costs of providing service to Chaparral.[123] Next, the impact of the Agreement on Virginia Power's total company revenues and expenses will be analyzed.[124] Included in this analysis will be an examination of any possible rate increases identified by the parties. The examination of the related risks and benefits placed on all other customers by the Agreement also will include consideration of each of the specific concerns raised by Staff.

Variable Cost Analysis

Virginia Power claims that the special rates of the Agreement, by design, recover all costs related to serving Chaparral plus a margin of profit.[125] Therefore, the revenues from the Agreement exceed Virginia Power's variable cost of providing service to Chaparral. Virginia Power demonstrates the net benefits of serving Chaparral under the Agreement by filing jurisdictional and customer class cost of service studies on both a "with" and "without" Chaparral basis.[126] The critical assumptions made by Virginia Power in regard to its claims are that: (i) because Chaparral is fully interruptible, no new generation capacity will be built to satisfy Chaparral's demand; and (ii) Virginia Power will accurately predict its hourly system lambda or marginal cost one day in advance. The Staff raises concerns regarding both of these assumptions, contending that the "Agreement offers the possibility that other Virginia Power customers' rates may go up more than they might otherwise . . . ."[127]

---

[121] *See*, Virginia Code § 56-235.2 C(ii).
[122] *See*, Virginia Code § 56-235.2 D.
[123] *Special Rates Order* at 11.
[124] *Id.*
[125] Exhibit EPH-10, at 4-7; Virginia Power Brief at 11.
[126] *See*, Exhibit EPH-P-11; Exhibit EPH-P-12; and Exhibit EPH-P-13.
[127] Staff Brief at 10.

First, Staff proposes that there be a definitive agreement describing the terms and conditions of physical interruption to assure that there is no need to acquire additional generation sources to supply Chaparral's load.[128] As proposed, the Agreement does not limit Virginia Power's right to interrupt service to Chaparral.

> The Company is not obligated to provide firm service under the Agreement. The Company shall have the right to interrupt the Customer's service with not less than ***Proprietary Time Interval*** notice to the Customer.[129]

Both Virginia Power and Chaparral acknowledge that Virginia Power has the right to interrupt Chaparral for any reason.[130] Furthermore, if Chaparral fails to interrupt when required by Virginia Power, Virginia Power can disconnect Chaparral through remotely activated disconnect switches.[131]

Nonetheless, Staff remains concerned that the Agreement fails to either mandate or guarantee when interruptions will occur. If, instead of interrupting Chaparral, Virginia Power opts to purchase or build capacity to serve Chaparral, revenues from the Agreement may not cover Chaparral's cost of service. Therefore, Staff seeks contractual language that will guarantee that Virginia Power will interrupt Chaparral when revenues earned from Chaparral fall below the cost of serving Chaparral.

While I agree with Staff that customers should not be harmed by decisions by Virginia Power to construct or acquire additional generation resources to supply Chaparral's load, I believe that Staff's recommendation to alter or amend the Agreement to require a delineation of when interruptions will occur is unworkable and would likely create more problems than it would solve. As the Agreement now stands, after notice, Virginia Power has the right to interrupt Chaparral for any reason. Adding language to mandate when interruptions will occur will not expand Virginia Power's authority to interrupt. Indeed, such language may limit or create uncertainty concerning Virginia Power's right to interrupt in situations not mandated by the Agreement. Furthermore, trying to fashion language that covers all instances where Virginia Power must interrupt Chaparral without any operating experience may produce an Agreement that is too rigid to allow the parties to maximize operating efficiencies.

A more workable approach would be for the Commission to hold Virginia Power to the promises that form the basis of the Agreement when conducting future earnings tests. Virginia Power represents that Chaparral is interruptible, that no new generation will be constructed to serve Chaparral, and that revenues from Chaparral will recover the marginal cost of providing service to Chaparral plus an additional ***Margin***. If actual results from operations show that

---

[128] *Id.* at 24-27.
[129] Exhibit Company-4, attached Exhibit 5.
[130] Hilton, Proprietary Tr. at 85; Clark, Tr. at 255-57.
[131] Exhibit EPH-33 at 11; Virginia Power Brief at 13.

Virginia Power failed to recover its costs and earn a ***Margin*** from Chaparral, then, depending upon the specific facts and circumstances, it may be appropriate for the Commission to impute revenue or eliminate expenses. Thus, in the future Virginia Power should have the burden of showing that it has performed as promised under the Agreement and that it has either: (i) not acquired, or (ii) has been reimbursed for, additional generation sources to supply Chaparral's load.

Second, Staff questions the adequacy of the ***GCA*** rate. As explained by Virginia Power, if it underestimates its day-ahead system lambda or marginal cost, Virginia Power may add a ***GCA*** rate per kWh for up to a ***Limited Number*** of hours to its hourly **Energy Charge**.[132] In essence, Virginia Power designed the ***GCA*** to cover the additional costs of purchasing energy for Chaparral when there would be an associated demand responsibility.[133] Staff contends that the ***GCA*** rate may not cover these associated capacity costs and, thus, may result in increased rates for other customers.[134] Staff supports its contention by attempting to compare the ***GCA*** rate with the first year revenue requirements associated with proposed new peaking units.[135] However, Staff does not propose a specific change in the Agreement associated with this issue. Instead, this issue is used as added weight for its other recommendations, especially, its proposed mechanism for the imputation of margins from lost off-system sales.

As with the issue raised regarding the interruptibility of Chaparral, issues concerning Virginia Power's day-ahead forecast of system lambdas and the adequacy and application of the ***GCA***, question Virginia Power's ability to deliver the basic promises of the Agreement. These issues all concern whether Virginia Power will recover its marginal cost plus a ***Margin*** from Chaparral. Subjecting Virginia Power's actual performance under the Agreement to Staff scrutiny may be the best safeguard that Virginia Power will operate as promised. Accordingly, subject to verification that Virginia Power has operated prudently and as promised under the Agreement, it is reasonable to conclude that the revenues from the Agreement will exceed Virginia Power's variable costs of providing service to Chaparral.

Total Company Revenues and Expenses

In this section attention shifts from the revenues and expenses associated with serving Chaparral to the impact of the Agreement on the rates of other customers. Virginia Power claims that the Agreement meets the statutory requirement of not unreasonably prejudicing or disadvantaging other customers. Indeed, Virginia Power asserts that its other customers actually benefit from its Agreement with Chaparral.[136] As explained by Virginia Power, margins earned from sales to Chaparral will be used to increase the level of stranded investment recovered by Virginia Power during the rate freeze instituted in Case No. PUE960036.[137] Virginia Power also

[132] Hilton, Proprietary Tr. at 73; Virginia Power Brief at 13.
[133] Hilton, Proprietary Tr. at 72.
[134] Staff Brief at 10-11.
[135] *Id.* at 11.
[136] Virginia Power Brief at 15.
[137] Exhibit EPH-33, at 8.

maintains that because it will match incremental fuel revenues with incremental fuel expenses, the fuel factor will be lower than if it served Chaparral on an average rate schedule.[138]

The Staff disagrees. Staff argues that the Agreement may increase the rates of other customers. First, service to Chaparral will increase Virginia Power's system lambda used as a basis for calculating the RTP hourly price.[139] Virginia Power estimates that this will produce an increase in hourly rates for customers served under rate schedule RTP of $0.25 per MWh.[140] To mitigate this increase, Staff witness Spinner recommends determining lambda values used to develop Chaparral's prices after RTP lambdas and prices have been calculated.[141] Mr. Spinner's recommendation is similar to the recommendation of public witness Thomas K. Warren of Merck who requests that Virginia Power exclude demand from Chaparral from the calculation of the demand thresholds that trigger the peak pricing hours under Schedule RTP.[142]

Second, Staff contends that sales to Chaparral limit Virginia Power's ability to sell power to the potentially more lucrative competitive wholesale or off-system markets.[143] Half of the margins earned from off-system sales are used to reduce deferred fuel balances.[144] The remaining half of the margins earned from off-system sales are credited to base rate margins.[145] Therefore, power sold to Chaparral instead of to the more lucrative off-system market will increase the fuel factor for Virginia Power's other customers. Put simply, Staff contends that other customers may benefit more from off-system sales than sales made to Chaparral.[146]

To address this possible loss of benefits from foregone off-system sales, Staff proposes instituting a ratemaking mechanism to impute an off-system sales margin for each MWh of sales to Chaparral.[147] This imputed margin will be the difference between the hourly market price for off-system sales at the PJM interconnection and Virginia Power's hourly system lambda. Staff further proposes that the margins recognized on the foregone off-system sales be treated as any other margin earned from off-system sales with 50% used to lower the deferred fuel balance and 50% added to base rate margins. Under the Staff's proposed mechanism, Virginia Power would retain the ***Margin*** earned from Chaparral.

Both of Staff's concerns are addressed separately below.

Schedule RTP Rates

---

[138] Virginia Power Brief at 15-17; Exhibit EPH-33, at 7.
[139] Staff Brief at 12; Exhibit HMS-19, at 14.
[140] *Id*.
[141] *Id.*
[142] Warren, Tr. at 30-31.
[143] Exhibit HMS-19, at 9.
[144] *Id.*
[145] *Id.*
[146] *Id.*
[147] Staff Brief at 12-16; Exhibit HMS-19, at 12, 26-27; Exhibit KBP-24, at 3.

Virginia Power answers Staff's RTP concerns by pointing out that any increase in the rates of customers served under Schedule RTP would be a result of the addition of new load, not the Agreement's special rates.[148] Section 56-235.2 D of the Virginia Code directed the Commission to establish guidelines for special rates "that will ensure that other customers are not caused to bear increased rates *as a result of such special rates*."[149] In this case, any increase experienced by customers served under Schedule RTP will result from increases in Virginia Power's system lambda or marginal cost. If Virginia Power's system lambda increases, the increase will arise from the new or additional sales to Chaparral, regardless of the rates paid by Chaparral. Consequently, Virginia Power is correct that if the rates to Schedule RTP increase, such an increase does not represent a violation of § 56-235.2 D.

On brief, the Staff counters by arguing that the low special rates of the Agreement may disadvantage customers such as Simms Metal.[150] According to public witness Mike Dunavant, Simms Metal, a metal recycler, operates under Schedule 10.[151] During the hearing, Mr. Dunavant summarized his testimony as follows:

> [W]e have no problem with Chaparral; we have no problem with Virginia Power; we just don't want to see anyone be disadvantaged because of these negotiations.[152]

As discussed above, § 56-235.2 C(ii) requires that special rates "will not unreasonably prejudice or disadvantage any customer or class of customers." The record does not show that the Agreement disadvantages customers served under Schedule 10. The Staff questioned the impact on Schedule RTP, not Schedule 10. Moreover, the Virginia Committee, which represents customers served under Schedule 10, filed a protest, but later requested that its status be changed from protestant to intervenor. The Virginia Committee did not participate in the hearing, nor did it file a brief. Thus, there is little in the record to indicate how customers served under Schedule 10 may be disadvantaged by the Agreement. But, even if customers served under Schedule 10, or Schedule RTP, are disadvantaged, such disadvantage must be weighed against the substantial benefits associated with gaining Chaparral as a customer in order to determine if the disadvantage is unreasonable. Therefore, Staff does not, and cannot maintain that the Agreement unreasonably prejudices or disadvantages customers served under either Schedule RTP or Schedule 10.

Staff's Off-system Sales Mechanism

Staff's proposed mechanism to impute margins from foregone off-system sales is easily the most controversial issue in this case. Though Staff supports approval of the Agreement, Virginia Power claims that Staff's proposed off-system sales mechanism, "if adopted, would create an

---

[148] Virginia Power Brief at 16.
[149] Emphasis added.
[150] Staff Brief at 12.
[151] Dunavant, Tr. at 32-34.
[152] *Id*. at 34.

insurmountable hurdle to electric utilities to 'fund' economic development."[153] More specifically, Virginia Power witness Hilton testified that if the Staff's proposal were adopted, "the Company certainly would not negotiate any further economic development rates with other potential customers in Virginia Power's service territory."[154] Mr. Hilton also stated that if Staff's proposal were adopted, "[t]he Agreement would have to be modified, terminated – something would have to be done . . . . It couldn't continue the way it is."[155]

On brief, Virginia Power contends that Staff's proposed mechanism to impute margins from foregone off-system sales is: (i) speculative; (ii) inconsistent with § 56-235.2; (iii) violates the stipulation in Case No. PUE960036; and (iv) contrary to the fuel factor accounting in Virginia.[156] Chaparral supports Virginia Power's arguments and further criticizes Staff's analysis for failing to include or consider: (i) transmission costs Virginia Power would incur in order to sell power to PJM; (ii) the relative value of Chaparral purchasing power around the clock versus spot sales; (iii) the value of the right to interrupt Chaparral; (iv) the value of demand charge revenues earned from Chaparral; (v) the value of long-term transmission charges paid by Chaparral; (vi) the value of GCA revenues under the Agreement; (vii) the value of GRC payments under the Agreement; and (viii) the in-state economic benefits Chaparral brings to Virginia.[157] Both Virginia Power and Chaparral recommend that the Commission approve the Agreement as filed without Staff's proposed mechanism to impute margins from foregone off-system sales.

Staff makes five arguments in defense of its proposed mechanism. First, Staff maintains that its proposed mechanism "ensures that the cost paid by Virginia Power retail customers allocated through the deferred fuel balance account will not be higher than it otherwise would have been without the Chaparral Agreement."[158] Second, Staff submits that its proposed mechanism "provides an incentive for Virginia Power to use its resources in an efficient manner."[159] Third, Staff asserts that if its proposal is not adopted Virginia Power's other customers may not receive the benefits of the Chaparral ***Margins***.[160] Fourth, Staff claims that its proposed mechanism is consistent with the Stipulation adopted by the Commission in Case No. PUE960296.[161] Finally, Staff insists that its proposal is consistent with past Commission precedent concerning the fuel factor.[162]

While I appreciate Staff's effort to ensure ratepayers benefit from this sale, I recommend that the Commission not impose Staff's proposed mechanism to impute margins from off-system sales. As discussed above, § 56-235.2 C requires a weighing or balancing of the benefits to be

[153] Virginia Power Brief at 3.
[154] Exhibit EPH-33, at 4.
[155] Hilton, Tr. at 350.
[156] Virginia Power Brief at 18-27.
[157] Chaparral Brief at 43-44.
[158] Staff Brief at 10-16.
[159] *Id.* at 16-18.
[160] *Id.* at 19-21.
[161] *Id.* at 21-22.
[162] *Id.* at 23-24.

derived from attracting Chaparral to Virginia against any disadvantages that other customers may experience as a result of the Agreement. Instead of undertaking such an analysis, Staff focuses on uncovering possible disadvantages to other customers and ensuring that such disadvantages do not occur. Thus, the first three arguments put forward by the Staff fail to address issues relevant to the application of § 56-235.2.

More importantly, the record does not support the propositions upon which Staff bases its proposal. For example, Staff assumes that each kWh sold to Chaparral represents a kWh that Virginia Power could have sold off-system on the spot market at the PJM nodal price.[163] However, Mr. Spinner fails to present any evidence regarding the historic level of sales made by Virginia Power into PJM or any other spot market.[164] Mr. Spinner was unable to respond to questions regarding the terms and conditions of spot market sales, such as service duration and the ability or inability to interrupt.[165] Whether Virginia Power sells power to the spot wholesale market may be a function of something other than price. An historical analysis of actual spot sales could have answered this question and provided a means of testing Staff's assumption.

Even if price is the sole factor in determining when off-system sales are or should be made, Virginia Power likely will incur costs other than its system lambda in order to make sales into PJM. Staff witness Spinner readily conceded that the PJM nodal price does not include transmission costs or other transaction costs.[166] Therefore, Mr. Spinner acknowledged that Staff's proposed mechanism would require further refinement before it could be implemented.[167]

Staff also assumes that future market prices for off-system sales will produce margins in excess of the ***Margin*** to be earned from Chaparral. Because of the emerging nature of the competitive wholesale market, I find this assumption also to be speculative. Virginia Power witness Hilton offered the following opinions regarding the future of the wholesale market:

> I'm still not sure what I know about the wholesale market. I saw some very high prices this summer. I don't know whether I'll see those prices next summer. I don't know to what extent there may be generation built. I understand that there are approximately 18,000 megawatts of generation being purchased right now to be on line in the next two years.
>
> My guess there is likely to be a glut in the wholesale market, but all of these things, I don't know. I can look at some very sparse pieces of information, but I can't draw any conclusion from them at this point in time.[168]

---

[163] *See*, Exhibit HMS-19, at 19.
[164] Spinner, Tr. at 243-44.
[165] *Id.* at 202-03, 214.
[166] *Id.* at 177-78, 202.
[167] Exhibit HMS-19, at 27; Spinner, Tr. at 178, 202.
[168] Hilton, Tr. at 354.

Staff's proposed mechanism trades the ***Margin*** Virginia Power will earn from each kWh sold to Chaparral for margins that may or may not be available in the wholesale market. Consequently, even if the Commission were to adopt Staff's recommendation and attempt to ensure benefits to Virginia Power's other customers, Staff's proposed mechanism would be too speculative to institute. As it is, in a proper weighing of the public interest as contemplated by § 56-235.2 C, the forgoing of off-system sales that may be more lucrative is a disadvantage that is easily offset by the substantial benefits associated with Chaparral locating in Virginia.

Furthermore, I have an additional policy concern regarding Staff's proposed mechanism. Traditionally, Virginians have enjoyed relatively low electricity prices when compared with other parts of the United States. As the electric industry moves towards competition, producers of electricity in Virginia may find markets outside Virginia more lucrative. Currently, Virginia jurisdictional customers benefit from the margins earned when Virginia utilities sell electricity off-system. However, changes in the structure of the electric industry, new legislation, or new regulations could limit the benefits Virginia customers receive from margins earned on off-system sales. Moreover, if producers of electricity in Virginia actively seek out more lucrative markets outside of Virginia, the cost of power required to serve Virginia jurisdictional customers may increase as distributors are forced to purchase electricity outside of Virginia to satisfy demand. In this case, Staff's proposed mechanism arguably will penalize Virginia Power if it fails to interrupt Chaparral, a Virginia customer, and sell that power to a market outside Virginia. Adoption of Staff's proposed mechanism sets a precedent that can only make it more difficult in the future to retain the benefits of low cost electricity produced in Virginia for Virginians.

While I recommend that the Commission reject Staff's proposed mechanism in this case, I, nonetheless, disagree with two of Virginia Power's arguments. First, Virginia Power argues that Staff's proposed mechanism violates the Stipulation in Case No. PUE960296. In the Stipulation, Virginia Power agreed, among other things, to freeze rates through February 28, 2002.[169] During the rate freeze period, two-thirds of all earnings between 10.50 percent and 13.20 percent return on equity, and all earnings in excess of 13.20 percent return on equity will be used to recover Virginia Power's regulatory assets.[170] Earnings used to recover regulatory assets will be determined pursuant to an annual earnings test.[171] Virginia Power argues that ratemaking adjustments as contemplated in Staff's proposed mechanism to impute margins from off-system sales can not be included in the earnings test of the Stipulation.[172] In this regard, Virginia Power relies upon Paragraph 5 of the Stipulation, which states:

> [t]he annual earnings test . . . shall be applied using the same methodology and comparable adjustments adopted by the Commission in Virginia Power's last base rate proceeding, Case No. PUE920041. The earnings test shall include only those

[169] Exhibit KBP-27, Stipulation at ¶ 4.
[170] *Id.* at ¶ 5.
[171] *Id.*
[172] Virginia Power Brief at 21-23.

> regulated revenues and related expenses and investments incurred in furnishing electric utility service to Virginia jurisdictional customers.

Based on this language, Virginia Power argues that "the earnings test may include only expenses and investments actually incurred. No imputation of revenues is permitted."[173]

Staff answers Virginia Power's argument by noting that Paragraph 3 of the Stipulation declares "[n]othing in this Stipulation shall impair the Commission's ability to exercise its lawful jurisdiction or carry out its lawful responsibilities or limit the Staff in the performance of its duties and responsibilities."[174] Furthermore, Staff points out that in Case No. PUE920041 the Commission imputed Job Development Credits.[175] Therefore, the imputation of revenues pursuant to its proposed mechanism is similar to an adjustment adopted by the Commission in Virginia Power's last base rate case.

I find that the language of the Stipulation does not preclude the imputation of revenues or the exclusion of expenses from the earnings test. Virginia Power attempts to stretch the word "incurred" into "actually incurred," implying that the Commission must perform the earnings test on a cash basis. But, as Staff witness Pate testified, the word "incurred" is used to refer to when something is reflected on a financial statement rather than when cash is received or dispersed.[176] Moreover, a broader interpretation of "incurred" is consistent with the language of Paragraph 5 of the Stipulation, which further specifies that adjustments to the annual earnings test:

> should reflect differences between financial reporting and Virginia regulatory accounting, the removal of costs excluded from the cost of service for Virginia ratemaking purposes, and adjustments necessary to reflect revenues at the actual pro-rated approved revenue level for the earnings test period.

Indeed, an adjustment to reflect revenues at the actual pro-rated approved revenue level for the earnings test period restates the actually incurred revenues for revenues that would have occurred if currently approved rates were in effect for the test period. Depending upon the direction of rates, the Commission may increase (impute) or decrease (exclude) revenues.

Accordingly, in conducting the earnings test provided for by the Stipulation, Staff and other parties should have an opportunity to review Virginia Power's implementation of the Agreement. As recommended above, if Virginia Power fails to act as promised, then, depending upon the surrounding facts and circumstances, it may be appropriate for the Commission to adjust earnings.

---

[173] *Id.* at 21.
[174] Staff Brief at 22.
[175] *Id.*
[176] Pate, Tr. at 322-23.

Second, Virginia Power similarly argues that Staff's proposed mechanism violates the Definitional Framework of Fuel Expenses for Virginia Power adopted in Case No. PUE950094.[177] In Case No. PUE950094 the Commission amended the then existing definition of fuel expense for Virginia Power to include one-half of the total accumulated energy margins from off-system sales. Virginia Power claims that the new language only "applies to the actual margin derived from the actual off-system sales of Virginia Power; it does not consider hypothetical sales or 'virtual' margins."[178]

The Staff, on the other hand, maintains that the Definitional Framework is flexible and susceptible to change as the industry evolves.[179] In addition, in the past, the Commission has adjusted actual fuel results to implement regulatory policy.[180] Therefore, the Staff asserts that the Commission may impute components into the fuel factor.[181]

The record in this case supports the Staff's contention that when necessary the Commission may adopt a fuel factor with imputed components. That Case No. PUE950094 dealt with an amendment to the Definitional Framework tends to demonstrate the flexibility of the Definitional Framework. The Commission's order in Case No. PUE950094 states that the Commission also amended the Definitional Framework in Case No. PUE940059.[182] Thus, even if Virginia Power were correct in that the Definitional Framework, as currently written, does not permit the imputation of components into the fuel factor, there is nothing in the record to suggest that the Commission could not alter the Definitional Framework to respond to changing circumstances.

In summary, I find the Agreement will not unreasonably prejudice or disadvantage any customer or class of customers. While it is important to monitor Virginia Power's performance under the Agreement and to adjust future earnings if Virginia Power fails to perform as promised, Staff's proposals, to ensure that other customers benefit under the Agreement, should not be adopted by the Commission. Specifically, the Commission should not implement Staff's recommendations in regards to the calculation of system lambdas nor should the Commission adopt Staff's proposed mechanism to impute margins from foregone off-system sales.

The Impact of the Agreement on System Reliability

Virginia Power provides that the Agreement will not jeopardize the continuation of reliable electric service by Virginia Power.[183] The Staff does not appear to raise any issues concerning the reliability of service.

---

[177] *Application of Virginia Electric and Power Company*, Case No. PUE950094, 1995 S.C.C. Ann. Rep. 362.
[178] Virginia Power Brief at 24; Exhibit EPH-33, at 6.
[179] Staff Brief at 23.
[180] *Id.* at 24.
[181] *Id.*
[182] 1995 S.C.C. Ann. Rep. at 363
[183] Virginia Power Brief at 18.

The Agreement permits Virginia Power to interrupt service to Chaparral upon notice of ***Proprietary Time Interval***.[184] In addition, the Agreement requires Chaparral to rectify or cease any operations that have or may have an adverse impact on Virginia Power's system.[185] Therefore, I find that the record supports a finding that the Agreement will not jeopardize the continuation of reliable electric service.

FINDINGS AND RECOMMENDATIONS

In conclusion, based on the evidence received in this case, I find that:

(1) The Agreement protects the public interest;

(2) The Agreement will not unreasonably prejudice or disadvantage any customer or class of customers;

(3) The Agreement will not jeopardize the continuation of reliable electric service;

(4) Staff's proposed mechanism to impute revenues from foregone off-system sales should not be implemented;

(5) Staff's proposal to establish more specific terms and conditions concerning physical interruption should not be adopted;

(6) The Agreement as filed should be approved; and

(7) Virginia Power should be directed to provide information to the Staff, upon request, documenting its performance under the Agreement.

I therefore **RECOMMEND** that the Commission enter an order that:

(1) **ADOPTS** the findings in this Report;

(2) **APPROVES** the Agreement; and

(3) **DISMISSES** this case from the Commission's docket of active cases and passes the papers herein to the file for ended causes.

COMMENTS

[184] Exhibit Company-P-5, attached Exhibit 5.
[185] Exhibit Company-4, at 16-18.

The parties are advised that any comments (Rule 5:15(e)) to this Report must be filed with the Clerk of the Commission in writing, in an original and fifteen (15) copies, within fifteen (15) days from the date hereof. The mailing address to which any such filing must be sent is Document Control Center, P. O. Box 2118, Richmond, Virginia 23216. Any party filing such comments shall attach a certificate to the foot of such document that copies have been mailed or delivered to all other counsel of record and to any party not represented by counsel.

Respectfully submitted,

_____

Alexander F. Skirpan, Jr.
Hearing Examiner